

The Federal Reserve as a Democratic Institution

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For quite some years, I have been fascinated by the issue of what we mean by a “democratic institution,” especially in the context of a nation’s central bank. As you might suspect, my interest in this subject has increased since I came to the Federal Reserve Bank of St. Louis last year.

Historically, some central banks have enjoyed considerable independence from the elected national government. Leading examples are the central banks of the United States, Germany and Switzerland. In recent years, the United Kingdom, Japan, New Zealand and a number of other countries have increased the independence of their central banks and required greater disclosure of central bank operations and plans. The charter for the new European Central Bank, charged with managing monetary policy for the euro, provides for great independence. Evidence on central bank performance in a variety of institutional settings suggests that independence improves results; this evidence has had much to do with decisions by many countries to increase the independence of their central banks.

Does central bank independence mean that societies have backed away from democratic control of this important institution, or does independence in fact increase democratic control? In our country, the question is: Just how democratic is the Federal Reserve System?

I will assume, for now, that central banking is inherently a governmental function. Federal Reserve Banks actually have a mixed public/private status under U.S. law, but given that the controlling statute is the Federal Reserve Act, I will ignore the public/private complications and

simply assume that the Fed is a governmental entity.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but I retain full credit for errors.

DEMOCRATIC ACCOUNTABILITY—THE BASICS

I am an economist, not a political scientist, and so my analysis reflects the perspective of an economist. Political scientists, however, have not written extensively on the Federal Reserve System; I think it fair to say that of important U.S. political institutions, the Federal Reserve is easily the most neglected in the political science literature. If I am mining deposits that rightfully belong to a different discipline, it is not because economists are imperialists, but because important issues have not been adequately examined by that other discipline.

When I studied American history in high school, an important topic was the development of our nation’s democracy. What I especially remember about democracy from those days, however, are the lessons my teachers taught about democracy from our own exercise of electing class officers. When running for office, we stated our positions on school matters. Our teachers taught us that the essence of democracy is voting. But, amazingly enough when you think about it, they also taught us that it was unseemly to actually campaign for office.

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Over the years, I came to appreciate just how wrong that teaching was. Voting means nothing without information and the competition of ideas. And what sort of democratic control do we really have through the ballot box when there are only two candidates but dozens of issues?

We live in a complex society. Direct democracy—voting on each and every issue in the style of a New England town meeting—is not feasible. In any given political campaign, we find that 10 or 20 issues are actively discussed. At the federal level, the government administers hundreds upon hundreds of programs of many different kinds. What we mean by democratic control over the government certainly does not mean that each of these programs is somehow controlled and disciplined by the voters at each election. We necessarily vote for our national leaders on the basis of a handful of specific issues and a generalized view about the candidates' qualifications to direct the administration of the vast enterprise of government.

Clearly, then, the issue of democratic accountability of any particular agency does not depend on the agency head being elected. In our federal system, only the President of the United States is elected by the entire electorate. The President appoints key officials, most subject to Senate confirmation. Following this standard pattern, the President appoints, and the Senate confirms, members of the Board of Governors of the Federal Reserve System.

Is appointment by the President and confirmation by the Senate all we mean by a democratic institution in the United States? I think not—I am convinced not—and that is my subject this evening.

THE FED'S GOVERNANCE STRUCTURE TODAY

I'll begin by briefly outlining the Federal Reserve's current governance structure. And I ask you to bear with me for about two full minutes of detail on who appoints whom when. The President appoints the seven members of the

Board of Governors of the Federal Reserve System; each member has a 14-year term. A term expires every other year. A member may serve one full 14-year term, or a partial term when a vacancy arises followed by a full 14-year term upon reappointment and Senate confirmation. Once appointed, a member may not be removed by the President but only through the impeachment process defined in the Constitution.

The President appoints the chairman of the Board of Governors from among the seven members. The chairman serves a four-year term, which begins upon Senate confirmation. The chairman can be reappointed during his term as a governor.

Twelve Federal Reserve Banks are scattered around the country. Each has a president selected through a process I will describe in a moment. The Reserve Banks are operational centers for Federal Reserve activities involving such services as handling currency, clearing checks and supervising banks.

In broad outline, each Federal Reserve Bank has a legal organization similar in many respects to that of any other corporation. A Reserve Bank is governed by a board of directors, subject to general oversight by the Board of Governors and the requirements imposed by Congress in the Federal Reserve Act.

When a Reserve Bank presidency becomes vacant, the Bank's board of directors conducts a search and screens candidates in the usual fashion. After that, in typical Federal Reserve fashion, the process gets a little more complex. The law provides for a check and balance—the Federal Reserve Act vests the Bank's board with power to appoint the president, but gives the Board of Governors power to approve the appointment. Thus the local board, with its mix of public and private interests, plays a major role, but its discretion to act is kept in check by the need to secure approval of the appointment from the Board of Governors. Suffice it to say that both boards take their respective roles in the process very seriously. Once appointed, a Reserve Bank president serves at the pleasure of the Bank's board and may be removed for cause by the Board of Governors.

The Reserve Bank president is the chief executive officer and has the typical corporate responsibility of administering the Bank's operations. The Bank president also sits on the Federal Reserve's main policymaking body, the Federal Open Market Committee. The voting membership of that committee is the seven members of the Board of Governors and five of the twelve Reserve Bank presidents. The president of the Federal Reserve Bank of New York is always a voting member, and the other four voting members serve on a rotating basis from among the other eleven Reserve Banks. In my case, for example, the vote rotates every three years among the presidents of the Federal Reserve Banks of St. Louis, Dallas, and Atlanta.

Where do the Reserve Bank boards of directors come from? Each board consists of nine members. A board member serves for a three-year term, which can be renewed for an additional three-year term. Six of the nine members are elected by the member banks within the Federal Reserve District; the other three are public members recommended by the local Federal Reserve Bank and appointed by the Board of Governors in Washington. The board of director's chairman and deputy chairman are drawn from the three public members and named by the Board of Governors.

Still with me? I hope so. The governance structure I have just described is, I believe, a source of great strength for the Federal Reserve System and a source of heightened democratic accountability compared to an arrangement in which, for example, the central bank is a cabinet department or subsidiary unit of the Treasury. I thought that before I came to the St. Louis Fed, and I think it now. The issue I want to explore is why this arrangement—which appears to be far removed from our usual model of democratic accountability—is in fact so successful.

THE FED'S JOB

To analyze the best form of political organization for any governmental entity, we need to be

clear about the responsibilities of that entity. What, exactly, is the Federal Reserve supposed to do?

Central bank responsibilities are not the same in all the countries of the world. Arrangements for operating the payments system and supervising banks vary from one country to another. Clearly, though, the essential central bank responsibility is control over monetary policy. While some countries can operate their monetary system by tying their currencies closely to the U.S. dollar or some other currency, U.S. monetary policy is not tied to an external standard. Before 1933, the Federal Reserve did conduct monetary policy by adhering to an external standard—the gold standard. Now, the U.S. dollar is pure fiat money, whose purchasing power is determined by the Fed's decisions and their interactions with the U.S. and world economies.

The Federal Reserve's prime responsibility is to maintain the purchasing power of the U.S. dollar and the stability of the aggregate U.S. economy. To maintain the purchasing power of the dollar, the Fed must regulate the supply of dollars so that it matches the demand for dollars at a stable price level, or a low and steady rate of inflation for those who prefer to put the policy goal that way.

The Federal Reserve, working closely with parts of the government like the U.S. Treasury and the Federal Deposit Insurance Corporation, is responsible for safeguarding the banking system and ensuring the smooth and reliable operation of the payments system. The Fed distributes currency to the banks as they require it to meet their depositors' needs. The Fed pulls suspected counterfeit bills out of circulation and turns them over to the Secret Service for verification and investigation. Most of us forget how important this function is; think of how chaotic your everyday life would be if you could not accept as a matter of course that the paper money you use is reliable and not subject to refusal because of fear of counterfeit bills? Extending this responsibility, the Fed oversees the banking system so that deposits can be used reliably and payments can be made cheaply and on schedule through paper check and electronic funds transfer mechanisms. In

short, an essential part of the infrastructure of a modern economy is the complete reliability of the payments mechanism and settlement system. Everyone must be able to make and receive payments reliably. Such reliability is as important to everyday life as a reliable supply of electricity.

Over a period of many years the Federal Reserve has developed extensive expertise in operating the payments system. There are many fascinating issues in this area, such as the continuing transition from paper-based payments to electronic payments. There are issues of efficiency and cost. With the odd exception of current concerns over the Y2K issue, however, these issues don't occupy the front pages of newspapers, or even the front pages of business sections of newspapers.

The most important bank regulatory issue still outstanding—one that could hit the front pages—concerns the problem of “too big to fail.” This is the issue of how best to approach the problem of very large banking organizations whose failure could be highly disruptive to the economy. If such firms are propped up by the government, then the spur to efficiency and proper evaluation of risk that arises from the risk of failure is removed.

Although the payments system and banking issues are important, they do not routinely appear in the daily news. What is regularly in the news is general monetary policy. Because of the importance of the Fed's policy responsibilities—a central bank's control of money creation and interest rates have large effects on the rate of inflation and the overall stability of the economy—these issues often appear in the political debate. Given that monetary policy decisions have such profound effects on society, it is perfectly natural and fully appropriate that we debate the way we exercise political control over the central bank.

ARE CENTRAL BANK FUNCTIONS INHERENTLY PUBLIC?

I have so far taken for granted that central bank functions are inherently public. We should recognize, however, that many activities essential

to daily life are organized in a market economy without the government taking primary responsibility. For example, the production and distribution of food, though influenced by government policies, is left almost entirely to the market. The fact is that we do not rely on government to put food on the table, and there is no reason to believe that the government could produce a cheaper and more wholesome food supply than the market economy does.

Economists have traditionally viewed control and regulation as an inherently governmental function. However, a few economists have argued that the government should exit the money business and leave the creation and management of money entirely to the private market. This subject is fascinating in its own right, but today I merely want to state my conviction that the traditional analysis is correct—the creation and control of money should remain a governmental responsibility.

Why, briefly, is money a government responsibility? The crux of the matter is not that money is especially important—food is also important, but the production and distribution of food works well in the private competitive market economy. The creation and distribution of money involves important “external effects,” as economists call them, that prevent a market solution from working satisfactorily. Let me illustrate this point by referring once again to counterfeit money. It is hard to see how a competitive market system would work to remove counterfeit bills from circulation. Anyone who inadvertently accepts a counterfeit bill has an incentive to pass the bill along to someone else rather than remove it from circulation. Removing the counterfeit provides a benefit to the society as a whole, but at a cost to the individual. Market exchanges work well when both parties benefit. When I buy apples at a roadside stand, the farmer and I both benefit from the transaction. When I remove counterfeit currency from circulation, society benefits, but I lose. For this reason, it is optimal for society to provide a government agency to assume responsibility for monitoring the quality of the currency and removing counterfeit and unfit bills for everyone's benefit. The

Fed charges counterfeit bills back to the banks that send them to the Fed, but this procedure is part of the enforcement mechanism and far from voluntary on the part of the banks.

This same principle applies to many other central bank activities. The governmental function provides benefits for the society as a whole that private market participants do not have the incentive to perform.

ISSUES OF POLITICAL ACCOUNTABILITY

I have argued that central bank responsibilities are inherently governmental. How, then, should we organize political control over the central bank?

The pattern in many countries historically was for the central bank governor to report to the treasury or finance ministry and for the governor to serve at the pleasure of the head of government. That was never the pattern in the United States. From its establishment in 1913, the Federal Reserve was an independent agency not subject to tight, everyday control by the President or the Secretary of the Treasury.

What I want to do now is analyze three considerations that are relevant to the issue of how best to organize political control over the central bank. These three issues concern the length of the political horizon, the time consistency problem and the advantages of single-purpose agencies.

Length of the Political Horizon

We often hear people say that one reason for central bank independence is that the political process inherently has a short horizon, extending at best to the date of the next national election, or perhaps the next presidential election. I am not convinced by this argument. My observation is that the political process is often, but not always, shortsighted. Our society in fact makes enormous investments in the future through government. Government taxes support schools, highways, national parks, a defense establishment and many other activities that have payoffs over years span-

ning many electoral cycles. Yes, we do see cities that pave streets and pick up trash just before a mayoral election. But I admit that I straighten up my house and rake the yard just before a party! I note that some analysts accuse corporations of shortsighted behavior in trying to pump up near-term earnings. In short, although all of us suffer from time to time from a compressed horizon that pays too little attention to the long-term consequences of our behavior, I do not believe that short horizons are an inherent feature of government behavior. When voters and their elected representatives understand the need for a long horizon, I believe that our political process can deliver the correct policies.

The Time-Consistency Problem

I'll illustrate the nature of the time-consistency problem by using an example directly relevant to monetary policy. Suppose a government were to promise everyone that the central bank would pursue a permanent policy consistent with zero inflation. If the government were successful in convincing people that the inflation rate would be zero, then long-term bond rates would fall to a level consistent with that expectation. Suppose that interest rate would be 3 percent. The government could then issue 100-year bonds and retire all its short-term debt. By doing so, the government would lock in the 3 percent interest rate for a very long time.

Having refinanced its debt this way, the government might be subject to the temptation to permit a certain amount of inflation. With 5 percent inflation, the real interest paid on the bonds would be minus 2 percent—the 3 percent money interest would not even cover the inflation rate. In the market, the interest rate on new debt might have to rise to 8 percent—5 percent to cover the inflation and 3 percent to reflect the real rate of interest. Clearly, it could well be in the interest of the government to create inflation once all of its debt had been locked up in 100-year bonds at 3 percent. Such a policy is said to be “time-inconsistent”; what is optimal given what has already taken place and given the expectations

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created by the promise to create zero inflation is not optimal as a repeated matter from the beginning. Should everyone be aware that the government is going to follow a policy of 5 percent inflation, then the government could never have issued the 100-year bonds at a 3 percent interest rate in the first place.

In a democratic society, we certainly want political arrangements that encourage actions that are optimal when followed consistently over time. Some of the characteristics of government that we expect to be maintained consistently over time are incorporated in the Constitution itself. These provisions bind all administrations, whenever elected, and help to avoid the time-inconsistency problem.

There was a time in our history when adherence to the gold standard had the characteristic of a constitution-like provision. In the end, the gold standard did not prove to be a satisfactory monetary system and the country abandoned that arrangement. However, we have not put in place a constitutional or constitution-like monetary standard to replace the gold standard. We continue to be faced with the possibility that any particular administration may find it in its short-run interest to pursue monetary policies that are not in the country's long-run interest. This fact is an important underpinning of the case for a degree of central bank independence from the administration in power. It makes no difference whether the administration is Democrat or Republican, for every administration is subject to the same underlying realities that policies designed for the short-run may not be optimal for the long run.

Advantages of Single-Purpose Agencies

An important problem voters face in choosing between two candidates is that the number of issues on which the candidates differ may be quite large. The vote for a particular candidate is always a compromise, no matter how superbly qualified a candidate is. Each of us has surely had the experience of being enthusiastic about a candidate but understanding that on some issues the candidate does not reflect our own views. We vote based on our view as to which candidate is

the best compromise.

Because the government faces an enormous number of issues at any one time, each elected official must craft compromise positions and decide which issues need to come out which way. An elected official understands full well that a vote will cost support among some constituents and gain support among others. An official needs to support positions in such a way as to construct a coalition among voters sufficient to gather enough votes at the next election to remain in office.

For the voters, an important advantage of a single-purpose agency is that the voter need not trade off views on that agency against views on policies followed by other agencies or areas of governmental responsibility. Unlike a member of Congress who may find himself trading off various policy concerns that have no inherent relation to each other, a single-purpose agency can be judged by the voters against its single responsibility. The Federal Reserve approximates a single-purpose agency. The Fed is the only agency that is responsible for the average rate of inflation in the economy over the long run; of course, short-run fluctuations in inflation are beyond the Fed's control, but the long-run trend of inflation is the Fed's responsibility and the electorate can and should judge the Fed on its performance in that regard.

This clear focus of responsibility has a great advantage in a democratic society. In my opinion, the Federal Reserve's substantial independence from the political process realizes that advantage to the maximum possible extent and is an element of great strength in U.S. political arrangements. If something goes wrong with the inflation rate, the electorate knows who is responsible and can identify the nature of the appropriate response. The President can appoint different leadership to the Federal Reserve by exercising his power of appointment every two years when a term on the Board of Governors expires. In contrast, if the Federal Reserve were set up as a cabinet department along the lines of the Treasury Department, voters would have to judge the severity of the inflation problem against all other dimensions of

the President's responsibility.

I also believe that the regional focus of the appointment process of Reserve Bank presidents reinforces central bank independence. It is important to realize that the Reserve Bank president is chosen through a regional process but is not particularly a regional representative. Reserve Bank presidents all understand that monetary policy is a national matter; we do not have regional monetary policies. My own example is instructive. I had no ties to the Eighth Federal Reserve District, except for an intellectual kinship reflecting my own education at the University of Chicago and the importance of Chicago-school economics at the Federal Reserve Bank of St. Louis since the late 1950s. The appointment process through Reserve Bank boards of directors rather than through political processes in Washington or state capitals buttresses the nonpolitical and independent status of the Federal Reserve.

INTERNAL DEBATE AND PUBLIC INFORMATION

I am sure that you agree that the high school view of democracy I described at the beginning of this lecture is extremely incomplete. It is, of course, essential that we be able to vote for our leaders holding elective office, but far from adequate to simply vote for the good guys and against the bums. Every one of us has experienced tremendous frustration in trying to deal with government agencies. These agencies, I emphasize, are established by laws written by our elected representatives and administered by elected executive officers—the President, a governor, a mayor. All too often we find such agencies to be unresponsive to our inquiries and secretive about their processes.

What makes for a high-performing government agency? I believe that we want each agency to be responsive to those for whom the agency provides services. We want the agency to be open to criticism. We want the agency to explain its policies and practices. These are essential characteristics

of accountability in a democratic society. Indeed, without these, the method for naming an agency head means little.

Would it make sense for the national electorate to vote directly to choose the chairman of the Federal Reserve System and 10 or 20 other key agency heads? I don't think so. I believe that the current method of selecting Fed leadership works well. The Board of Governors heads the Federal Reserve System, and the board's members are appointed by the President and confirmed by the Senate. The regional Federal Reserve Banks have leadership selected by local boards of directors drawn from the communities all over the United States. The diversity of methods to choose Fed leadership provides, I believe, a diversity of views and serves as a great source of strength for the central bank in the United States.

The Federal Reserve, I believe, ranks far up in our nation's list of agencies in terms of responsiveness and openness. The Fed is close to the constituents it serves by virtue of numerous meetings of advisory boards and programs out in the Federal Reserve Districts. I travel extensively throughout the Eighth Federal Reserve District, meeting with groups of bankers, business and community leaders, newspaper editors and elected officials. We have frequent meetings of advisory groups at the main office in St. Louis. Our three Branches in Memphis, Louisville and Little Rock have many contacts with their local communities. The Fed provides numerous publications aimed at both professional audiences and community and lay audiences.

In addition, members of our operating staff in check clearing, electronic payments and currency-handling operations meet frequently with those for whom they provide services. Bank supervisors and examiners meet frequently with banks not only in the context of bank exams themselves but in more general contexts.

An element of Reserve Bank accountability not well understood by the general public, or even by public finance experts, stems from the Monetary Control Act of 1980. That Act requires the Fed to charge for many of its services at cost. Federal Reserve Banks compete with private firms

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in check-clearing; indeed, the Fed has about one third of this business and the private market two thirds. Most governmental agencies providing services in competition, or potential competition, with the private sector have their positions protected either by grants of monopoly power or by substantial subsidies that permit the government agencies to charge prices far below cost. The requirement that the Fed price services at cost imposes a market discipline that supplements political accountability.

At the national level, Fed governors are frequently seen on Capitol Hill providing testimony on a wide variety of subjects. The chairman's testimony receives wide coverage in newspapers and on television. I think it is fair to say that anyone who desires contact with the Fed has many opportunities to raise questions and comment on what the Fed does.

My observation, certainly now and I honestly believe before I came to the Federal Reserve Bank of St. Louis, is that the Federal Reserve is more open than any other agency of government. A striking feature of the Federal Reserve System is that a substantial degree of difference of opinion on monetary policy issues is on open display. The Federal Open Market Committee voting system provides for formal dissenting views and an accompanying paragraph in the minutes explaining the reason for the dissent. Fed publications from the Board of Governors and the Reserve Banks often display differences of views on controversial matters. The press refers to certain members of the FOMC as "hawks" or "doves." I believe that all of us in the Fed are engaged in a common effort, but we are not bashful about airing how our views may differ on how to reach the common objective. We do have professional differences that match differences on monetary policy among academic and business analysts. When

people talk to me about internal debates, I always say that you can assume that all of the debates you see on the outside are also conducted on the inside.

In short, the Federal Reserve is an extraordinarily healthy and productive organization. I believe that the Fed's degree of democratic accountability is extremely high. The Fed is responsive, open and approachable. It maintains high standards of accountability and integrity in its internal operations and the separation of personal financial gain from access to inside information.

CONCLUDING COMMENT

For me, the key question of the Federal Reserve's democratic accountability is whether tighter control by elected officials would improve that democratic accountability. I am convinced not. I believe that the present openness and healthy internal debate would not survive intact if the Federal Reserve were more tightly controlled by the elected national administration. If the Fed were organized as a cabinet department, I believe it inevitable that certain compromises with monetary policy would be struck as a part of the normal process of building coalitions, striking compromises across different areas of government. The fact that the Federal Reserve is essentially a single-purpose agency with a significant degree of independence from day-to-day political considerations provides for a clear locus of responsibility and a clear agency objective.

It is often said that the Federal Reserve is independent *within* the government, not independent *of* the government. I am convinced that the Fed's structure, far from impairing political accountability, enhances it.